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## Case Comment

# Re Floor Fourteen Ltd in the Court of Appeal

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**Case:** Lewis v Inland Revenue Commissioners Times, November 15, 2000 (CA)

***Comp. Law. 215** There is now an extensive literature chronicling the barriers that liquidators face in trying to bring avoidance proceedings under the Insolvency Act 1986.[1] One such barrier is the treatment of the liquidator's legal costs. Broadly speaking, the liquidator is entitled to an indemnity out of the company's assets in relation to the costs incurred should the action fail.[2] However, the value of the indemnity depends on whether the costs are treated as an expense of the liquidation ranking for payment ahead of preferential creditors and any floating charge. In *Re MC Bacon (No. 2),* [3] Millett J. held that the liquidator could not recoup the costs of an unsuccessful action against the defendant bank as a liquidation expense. The liquidator contended that his costs should be treated as an expense "properly chargeable or incurred by … the liquidator in preserving, realising or getting in any assets of the company" within rule 4.218(1)(a) of the Insolvency Rules 1986. The judge ruled that the relevant cause of action was not an asset of the company as it vested in the liquidator and only arose after the liquidation had commenced.[4] It followed that the costs were not incurred in realising or getting in "any assets of the company" for the purposes of rule 4.218(1)(a). The apparent consequence of *MC Bacon (No. 2)* is that the liquidator's costs of proceedings under sections 213, 214, 238, 239 and 245 of the Insolvency Act 1986 can only be recouped from assets available for distribution to unsecured creditors and therefore rank as an unsecured claim. The decision has been described as "a formidable obstacle to those who wish to encourage liquidators to take on avoidance actions".[5] However, as the Court of Appeal's decision in *Re Floor Fourteen Ltd, Lewis v. Commissioner of Inland Revenue* [6] shows, *MC Bacon* continues to find favour in the higher courts.

In *Floor Fourteen* the company was in voluntary liquidation. Its liquidator applied for a declaration that he was free to use asset realisations in his hands to fund preference and wrongful trading proceedings against the company's former directors.[7] The directors and preferential creditors contended that the liquidator was not at liberty to use the assets to meet the costs of the proposed litigation in the light of *Re MC Bacon.* The preferential creditors (meaning the various Crown agencies, including the Inland Revenue, whose claims enjoy preferred status under section 386 and Schedule 6 of the Insolvency Act 1986) had an axe to grind because their claims rank for payment after liquidation expenses by virtue of section 175(2)(a) of the Insolvency Act 1986. At first instance,[8] the deputy judge declined to follow *MC Bacon,* preferring instead the contrary view expressed *obiter* by Phillips and Morritt L.JJ. in *Katz v. McNally.* [9] He held that costs could be recouped as an expense under section 115 of the Insolvency Act 1986 as long as they were properly incurred and that this was so whether or not they fell within rule 4.218(1). He based his conclusion on the view that section 115 should be read as being logically prior to rule 4.218(1). This rule, the deputy judge said, merely determines the order in which certain expenses are paid. It did not bar the court from treating other items of expenditure as an expense within section 115 and according them priority. Contrary to received wisdom, the deputy judge also indicated that the recoveries of successful preference or wrongful trading proceedings would, in any event, fall within rule 4.218(1)(a). He took the view that any monies recovered became assets of the company within the rule at the point of recovery, albeit assets held subject to the statutory trust for unsecured creditors. He agreed that rule 4.218(1)(a) could not extend to the costs of *unsuccessful* proceedings as these did not produce an "asset". However, for good measure, he held that costs could be recouped under rule 4.218(1)(m) as a "necessary disbursement", regardless of the outcome of the proceedings, as long as the costs were rendered necessary by the proper performance of the liquidator. For all these reasons, the deputy judge felt able to grant the liquidator's application. The preferential creditors appealed on the ground that, although the court had a discretion to allow the liquidator to recoup his costs as an expense, recoupment was not an automatic right. In their view, the effect of the deputy judge's decision was to

entitle the liquidator, in advance and as of ***Comp. Law. 216*** right, to treat the costs of the proposed litigation as an expense. Their problem was that the costs of proceedings might well exhaust the available assets whereas, on an immediate distribution, they would be paid out of the assets ahead of unsecured creditors.[10]

The appeal was allowed. In delivering the court's judgment, Peter Gibson L.J. both restated and clarified the orthodox position taken in *MC Bacon.* The court considered itself bound by its own earlier approval of *MC Bacon* in *Re RS&M Engineering Co. Ltd, Mond v. Hammond Suddards.* [11] First, it disagreed with the deputy judge on the relative status of section 115 and rule 4.218. By a combination of section 411 and Schedule 8, paragraph 17 of the Insolvency Act 1986, the Act contemplates that the Insolvency Rules will make provision for what fees, costs, charges and other expenses can be treated as liquidation expenses. With this in mind, Peter Gibson L.J. thought that it would produce an odd result if section 115 were to be construed as meaning that *all* winding-up expenses have priority as long as they are properly incurred. In his view, section 115 deals only with the priority of expenses as against other claims, *e.g.* those of preferential creditors and unsecured creditors. It is rule 4.218 that determines which expenses are to be treated as liquidation expenses in the first place. Rule 4.218 also governs how those expenses rank for payment *inter se.* It follows that the liquidator can treat any costs *falling within* rule 4.218(1) as liquidation expenses and recoup them *as of right.* However, section 115 does not confer an independent statutory right on the liquidator to recoup costs *falling outside* rule 4.218(1) as an expense. It was critical therefore to determine whether the costs of the proposed litigation were caught by rule 4.218.

On this question, the Court of Appeal was emphatic in its support for *MC Bacon.* Successful avoidance or wrongful trading proceedings do not involve the “preserving, realising or getting in [of] any of the assets of the company”. Any monies recovered in such proceedings do not represent property of the company existing at the commencement of the liquidation as the rights of action arise only after liquidation and can only be pursued by a liquidator.[12] The costs of recovery cannot therefore fall within rule 4.218(1)(a). The court agreed with the deputy judge that the costs of unsuccessful proceedings could not fall within rule 4.218(1)(a). However, it rejected his view that such costs were “necessary disbursements” within rule 4.218(1)(m).

In line with *MC Bacon* and *Mond,* the Court of Appeal assumed that the court did have a residual discretion to allow the liquidator to recoup costs not falling within rule 4.218 from the company's assets in his hands. Peter Gibson L.J. was disinclined to speculate as to the precise source and scope of the discretion. It was suggested that the court should adopt a cautious approach in exercising the discretion, especially in cases where preferential creditors who might otherwise receive a dividend object to the use of the available assets to fund speculative litigation. It was felt that there was insufficient information before the court for it to be able to exercise the discretion in the present case. However, it was accepted that the liquidator was entitled to make a fresh application on fuller evidence to the Companies Court.[13] It is clear from both *Floor Fourteen* and *Mond* that the same principles would apply in compulsory liquidation.

There are very good reasons why the courts were anxious to prevent the liquidator recovering the costs of unsuccessful litigation as an expense in the cases of *MC Bacon* and *Mond.* In *MC Bacon,* the object of the proceedings had been to avoid the defendant's floating charge. If the liquidator had been allowed to recoup his costs as an expense, the floating charge vindicated in the proceedings would have been subordinated to the costs of an unsuccessful challenge to its validity. In *Mond,* it was held that the funds in the liquidator's hands were caught by a floating charge. As in *MC Bacon,* it would have been unfair if the court had allowed the liquidator to recoup his costs from funds to which the chargeholder had successfully established he was entitled in the litigation. However, considerations of this nature were not in play in *Floor Fourteen.* Overall, the position for liquidators remains uncertain. The Court of Appeal's acknowledgment that there is a residual discretion is of little encouragement. No one is sure how this discretion operates. At the moment, it is nothing more than a vague gloss on the statutory provisions. The best one can say for *Floor Fourteen* is that it does conclusively settle the question as to the precise relationship between section 115 and rule 4.218. Unfortunately, it remains difficult for liquidators to contemplate proceedings unless unsecured creditors can be persuaded to provide a fighting fund. There is, of course, now the option of conditional fees. However, even if the liquidator can engage his own legal team on a “no win, no fee” basis, he remains liable to pay the other side's costs if the proceedings are unsuccessful. It is possible to insure against this risk but so-called “after the event” insurance is not cheap.[14] At the moment, conditional fees are the only realistic option as other creative attempts to spread the liquidator's risk, for example by assigning a future share of recoveries to a funder in return for financing and protection on costs, have been blocked by the courts.[15] If we seriously expect liquidators to make use of the armoury at their

disposal, then a strong case can be made for a full review of the expenses rules at least insofar as they apply to the costs of insolvency litigation. At the very least, they should be updated to take account of the conditional fee regime. It is the writer's view that *Floor Fourteen* does not even guarantee that the liquidator can recoup the premium payable for adverse costs insurance as of right. It must be arguable that recoupment should be allowed in the exercise of the residual discretion. A better option from the point of view of insolvency practitioners would be to amend rule 4.218 to make it clear that the premium is a “necessary disbursement” falling within rule 4.218(1)(m) which could therefore be recouped as of right. Removal of the Crown's preferential creditor status would also have helped in the present case!

**Adrian Walters** *Editorial Board*

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1. See *e.g.* L. Doyle, *Insolvency Litigation* (Sweet & Maxwell, 1999), chapters 4 and 5 (and the works therein cited); R. Parry, “Funding Litigation in Insolvency” (1998) *Company Financial and Insolvency Law Review* 121; G. Bompas and H. Boedinghaus, “Funding Litigation and Assigning Claims” in *Butterworths Practical Insolvency* (looseleaf); and A. Walters, “Staying Proceedings on Grounds of Champerty” [2000] 1 *Insolvency Lawyer* 16.

2. *Re Wilson Lovatt & Sons Ltd* [1977] 1 All E.R. 274, Ch D.

3. [1991] Ch. 127; [1990] 3 W.L.R. 646; [1990] B.C.L.C. 607; [1990] B.C.C. 430, Ch D.

4. See further *Re Oasis Merchandising Services Ltd* [1997] 2 W.L.R. 764, [1997] 1 All E.R. 1009, [1997] 1 B.C.L.C. 689, [1997] B.C.C. 282, CA.

5. D. Milman and R. Parry, *A Study of the Operation of Transactional Avoidance Mechanisms in Corporate Insolvency Practice* (Insolvency Lawyers Association Research Report, July 1997), p. 17.

6. *The Times,* November 15, 2000; *Independent,* December 18, 2000.

7. On the facts, the liquidator's legal advisers had agreed to act on the basis of a conditional fee. It follows that the liquidator was, in effect, asking the court's permission to use the assets to fund payment of costs and disbursements not covered by the conditional fee agreement.

8. [1999] 2 B.C.L.C. 666, [2000] B.C.C. 416. See A. Walters, “Round Up: Corporate Insolvency” (2000) 21 *Company Lawyer* 262.

9. [1997] 2 B.C.L.C. 579, [1997] B.C.C. 784; [1998] B.P.I.R. 30, CA.

10. On the facts, a dividend to preferential creditors of just under 44 pence in the pound.

11. [2000] Ch. 40; [1999] 3 W.L.R. 697; [1999] 2 B.C.L.C. 485; [2000] B.C.C. 445; [1999] B.P.I.R. 975, CA. See further Walters, n. 8 above.

12. The recoveries are held on statutory trust for distribution by the liquidator to unsecured creditors and are never owned by the company: see also *Re Oasis Merchandising Services Ltd* [1997] 2 W.L.R. 764, [1997] 1 All E.R. 1009, [1997] 1 B.C.L.C. 689, [1997] B.C.C. 282, CA.

13. This sort of application was seen as analogous to an application by a minority shareholder for an indemnity in respect of the costs of a derivative action under the principle in *Wallersteiner v. Moir (No. 2)* [1975] Q.B. 373; [1975] Q.B. 508 (Note); [1975] 2 W.L.R. 389; [1975] 1 All E.R. 849, CA.

14. In the present case, the liquidator had been quoted a premium of £3,750 for limited cover of up to £25,000.

15. Most notably by the Court of Appeal in *Re Oasis Merchandising Services Ltd* [1997] 2 W.L.R. 764, [1997] 1 All E.R. 1009, [1997] 1 B.C.L.C. 689, [1997] B.C.C. 282.


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